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THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 01/04/84 **Number:** 168869CA **Due By:** _____

Subject: Cabinet Council on Economic Affairs - Thursday, January 5, 1984
8:45 A.M. - Roosevelt Room TOPIC: Financial Market Developments

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☑	☐
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
GSA	☐	☐
EPA	☐	☐
OPM	☐	☐
VA	☐	☐
SBA	☐	☐

	Action	FYI
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
Baker	☑	☐
Deaver	☐	☐
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Mc Farlane	☐	☑
Svahn	☑	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
_____	☐	☐
CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/	☐	☐
CCHR/Simmons	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS: The Cabinet Council on Economic Affairs will meet on January 5, 1984 at 8:45 A.M. in the Roosevelt Room.

The agenda and background papers are attached.

DCI EXEC REG

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☐ Katherine Anderson
☑ Tom Gibson
Associate Director
Office of Cabinet Affairs
-2800

☐ Don Clarey
☐ Larry Herbolsheimer

L-300B

THE WHITE HOUSE

WASHINGTON

January 3, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the January 5 Meeting

The agenda and papers for the January 5 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will review recent monetary policy and financial market developments. A paper, prepared by Under Secretary of the Treasury Sprinkel, on "Monetary Policy: Potential Threat to the Expansion" and one by Gregory Ballentine on "Recent Behavior of M1: The Problem of Seasonal Adjustment" are attached.

A third paper describing recent developments in financial markets will be completed shortly and distributed tomorrow.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

January 5, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Financial Market Developments and Monetary Policy (CM # 111)

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

January 3, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: J. Gregory Ballentine

SUBJECT: Recent Behavior of M1: The Problem of Seasonal Adjustment

M1 is now within the target range set by the Fed, though it is near the bottom of the range. The recent behavior of M1 has raised at least two issues. They are:

(1) Will M1 continue along a growth path within the range or will the more recent slow growth of M1 cause M1 to fall below the range?

(2) Has the growth in M1, in going from slightly above the range to the bottom of the range, been too precipitous a drop that may lead to a marked slowdown in economic activity in early 1984?

Both of these issues depend partially on a careful reading of the deceleration in money growth over the last few months. A rapid deceleration in the rate of growth of money has consistently led to some slowdown in economic activity. The more rapid the deceleration, the greater the slowdown has tended to be. It is, however, difficult to judge the rapidity of the recent slowdown because of uncertainty over the seasonal adjustments applied to the money figures.

Normally, seasonal adjustments should correct for factors that are repeated year after year at given times of the year. Such seasonal adjustments would not normally tend to vary a great deal from one year to the next. Recently, because of the various innovations in financial markets and the sharp changes in monetary policy, the Fed's seasonal adjustment factors have varied a great deal from year to year. That is, they appear to be correcting not only for what is normally thought of as seasonal factors (e.g., Christmas season), but other factors that are not repeated each year, such as the introduction of new kinds of accounts or a rapid change in monetary growth in the preceding year or two. These changes in the seasonal adjustment factors from year to year inevitably must call into question very precise statements about the movement of money over a short period of time.

The high variability of the seasonal adjustment factors can be indicated by looking at the 1983 M1 numbers using the seasonal adjustment factors the Fed actually used, and the 1983 numbers using the seasonal adjustment factors that were in place for 1982.

Annualized Month-to-Month Percent Changes

	M1 Current Seasonals	M1 With 1982 Seasonals
1983		
Jan.	10.2	14.6
Feb.	24.9	19.7
Mar.	17.1	17.5
Apr.	-2.6	6.1
May	29.8	15.8
June	10.7	5.6
July	9.3	5.7
Aug.	2.9	3.0
Sept.	0.9	2.2
Oct.	1.9	8.1
Nov.	0.5	5.6

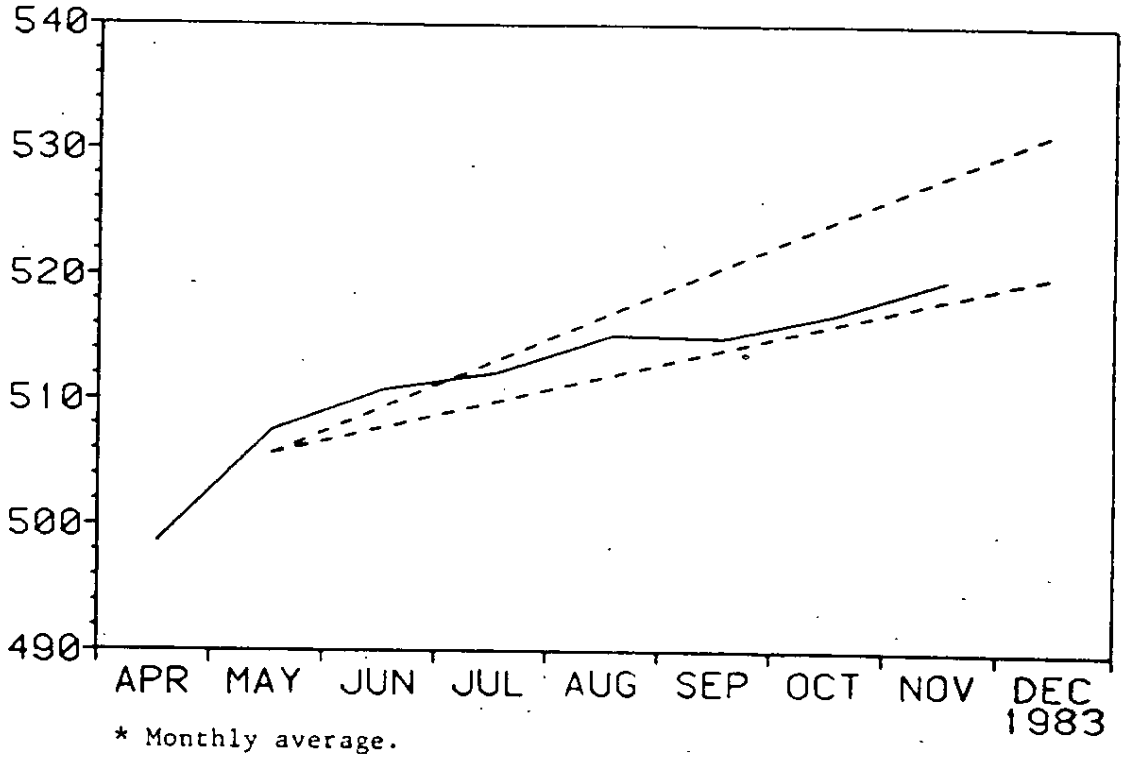
As you can see, if the 1982 seasonals were used, the apparent rapid slowdown in monetary growth that has been observed using the reported M1 figures would not have been observed. There are reasons, however, to believe that the 1982 seasonals are distorted somewhat. There are also reasons that lead to some mistrust of the 1983 seasonals as well as all the seasonals over the past several years of rapid financial market innovation.

An alternative set of seasonal adjustment factors has been experimented with by the Fed. One apparent advantage of the experimental factors is that they have not been as highly variable from year to year as the official factors. Nonetheless, Fed officials have little reason now to say that one set of seasonals should be preferred to the other. The current M1 series with the experimental seasonals is shown below, along with the movement of M1 relative to the range using the experimental seasonals and the official seasonal adjustments.

Annualized Month-to-Month Percent Changes

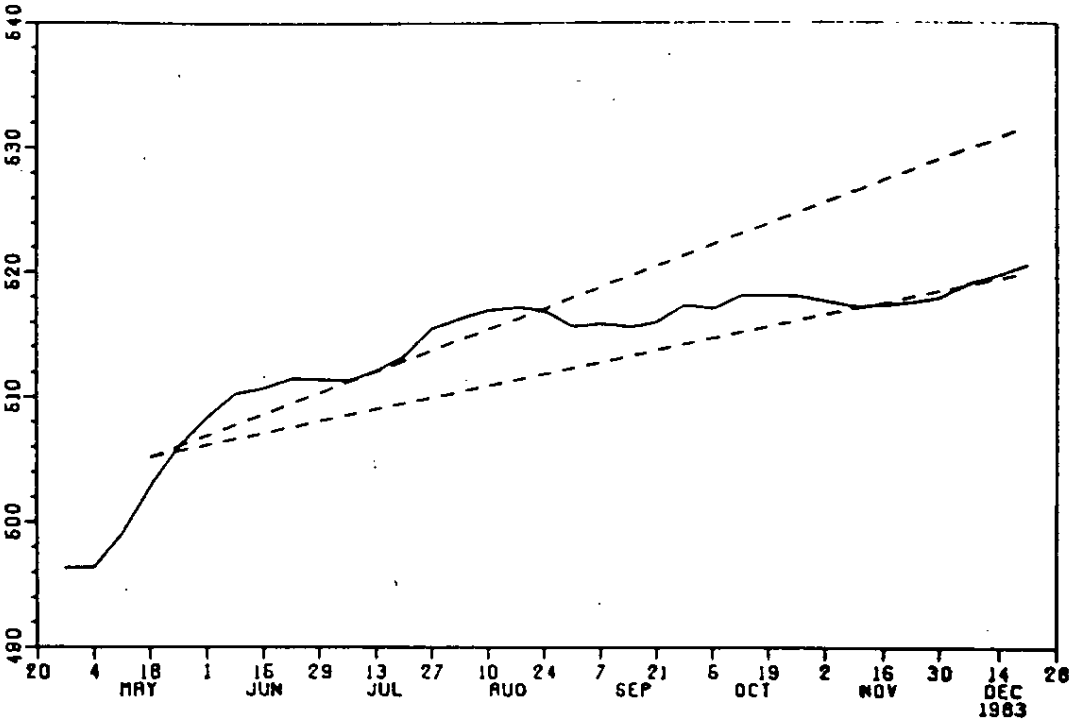
1983	M1 Current Seasonals	M1 With Experimental Seasonals
Jan.	10.2	6.3
Feb.	24.9	24.2
Mar.	17.1	19.6
Apr.	-2.6	0.0
May	29.8	21.4
June	10.7	7.6
July	9.3	3.3
Aug.	2.9	7.0
Sept.	0.9	-0.5
Oct.	1.9	4.7
Nov.	0.5	6.5

M1 (EXPERIMENTAL SEASONAL)* VS TARGETED
($, BILLIONS)



* Monthly average.

M1 : TARGETED AND OFFICIAL FIGURES *
($, BILLIONS)



* Four-week moving average.

If, in fact, the experimental M1 figures had been reported rather than the official figures, there might have been less concern about recent monetary behavior. Unfortunately, there is no clear reason to suspect that the experimental series is more accurate than the official series. It is true, however, that the variability of the official seasonals from year to year and the difference between the official series and the experimental series indicates that some caution should be used in interpreting money growth over short periods of time.

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

January 3, 1984

MEMORANDUM FOR CABINET COUNCIL ON ECONOMIC AFFAIRS

From: Beryl W. Sprinkel

Subject: Monetary Policy: Potential Threat to the Expansion

The Threat

In the short run, the rate of money growth is closely correlated with economic activity. Historically a change in the rate of money growth, if sustained for a period of about six months or longer, has been associated with a similar swing in economic activity within six to nine months.

Since mid-summer there has been a drastic slowing in the rate of money growth; from July through November, M1 grew at an annual compound rate of only 1.5%. If money growth continues at a near-zero pace for another month or two, historical experience would imply a downturn in the economy by next spring or summer. Aside from the obvious political consequences, another economic downturn would jeopardize our strategy for an orderly resolution to the international debt situation and would worsen the outlook for the budget deficit.

In the last three weeks, M1 has shown more significant, positive growth; this is an encouraging sign that the period of flat money growth may be ending. But weekly data on the money supply are notoriously erratic, so one cannot confidently draw inferences from a few weeks of money data. If the most recent money supply numbers are the beginning of a pattern of more significant growth, the danger to the economy will be greatly reduced. But if money growth does not continue to show positive growth in the weeks and months immediately ahead, monetary policy will become a serious threat to continued economic expansion through 1984.

There are always uncertainties associated with predicting either the timing or the intensity of economic turning points; economic theory and forecasting only allow us to make probabilistic statements about the economic outlook. In a world of uncertainty, the best economic policies are those that, given current information, minimize the risk to future economic performance. Rather than minimizing future risk to the economy, a prolonged period of near-zero money growth will unnecessarily expose the economy to the very real danger of another recession. The longer the money supply shows little or no growth, the higher the probability that it will precipitate an undesirable slowing of economic activity within the next year.

It is important to recognize that some moderation in the rate of economic expansion is to be expected as the recovery proceeds. The flash estimate for real GNP growth in the fourth quarter shows a slowing to 4.5%, compared to the 9.7% and 7.6% rates of the preceding quarters. With some slowing of real growth inevitable, it is also desirable to observe a similar slowing in the rate of rise of nominal GNP; if not, a growing share of nominal GNP will be attributable to rising inflation as real growth moderates. The risk associated with current monetary policy is not that some slowing in nominal GNP growth will occur; some slowing is warranted. The threat is that monetary policy will induce an unacceptable downturn in real economic activity.

The Behavior of M2

The fact that the growth of M2 remains well-within its target range leads some analysts to be unconcerned about the implications of restrained M1 growth. However, M2 historically has been an unreliable predictor of either economic activity in the short run or inflation in the long run. For example, there was no important deceleration of M2 preceding the 1981-82 recession; to the contrary, on a fourth-quarter to fourth-quarter basis, M2 accelerated in 1980 and 1981 and was at, or above, the top of its prescribed target range. Observing M2 growth at the time would therefore have given policymakers no cause for concern about a troublesome decline in the economy. In addition, M2 was not a reliable predictor of either the acceleration of inflation in 1978-1981 or its deceleration thereafter. Based on recent historical experience, a well-behaved M2 series provides little comfort for future economic performance. In contrast, M1 growth has consistently been a reliable predictor of economic activity in the short run and inflation over the long run.

The Dangers of Discretionary Monetary Policy

The record of monetary actions over the past year and a half is a good illustration of the risks inherent in discretionary monetary policy, designed to fine-tune movements in economic activity. Beginning in the late summer of 1982, money growth accelerated rapidly and remained at a high rate of growth for about a year. Despite the uncertainty at the time about the effects of financial deregulation on the monetary data and the implications for velocity behavior, the strength and timing of the subsequent economic expansion was consistent with the historical short-run relation between money growth and economic performance. While many were, and continue to be, surprised by the strength of the recovery, those who carefully analyzed the behavior of the monetary aggregates were not, and are not. The sustained period of strong money growth in late 1982-early 1983 foreshadowed strong economic performance in 1983.

As we can all attest, the short-run real economic gains generated by accelerating money growth are certainly enjoyable; it is precisely these gains that have enticed policymakers over the past two decades to pursue monetary policies that were, over the long run, inflationary. But it is important to recognize that a policy of accelerating money growth to stimulate the economy has significant economic risks associated with it.

The first risk is that the monetary acceleration will turn out to be too much for too long, and will generate new inflationary pressures and rising interest rates. While the flatness of money growth over the past four or five months limits the inflationary threat associated with the year of very rapid money growth that preceded it, a resumption of rapid money growth would quickly renew those concerns. This is a danger of which the financial markets are acutely aware. Signs that the Fed has reverted to inflationary policies are likely to be quickly discounted by the financial markets, resulting in falling prices for financial assets and rising interest rates.

The second danger associated with a year of rapid monetary expansion arises when money growth is again decelerated. No one believed that the 14% money growth that occurred from August 1982 to July 1983 could continue forever without precipitating a financial and economic disaster. Such a monetary acceleration presents the very difficult policy problem of curtailing money growth enough to contain any inflationary threat, but without generating a protracted period of monetary restriction.

A sustained period of monetary contraction is especially risky when it occurs in an environment characterized by significant uncertainty about Fed intentions. This uncertainty disrupts private economic planning, helps hold interest rates up, and thereby impedes the pace of capital formation. While the long-run risk of rising inflation is one which we surely cannot afford to ignore, the short-run risk of monetary restriction is the one that, in my view, now requires immediate attention and concern.

These risks are illustrative of the dangers inherent in using monetary policy to fine-tune the economy. In theory, discretionary fine-tuning and the flexibility it implies appears to be a reasonable approach to policymaking. However, well-intentioned, well-designed stabilization policies can be turned into destabilizing forces when incomplete and inaccurate contemporaneous economic data and imprecise economic forecasts are plugged into a policymaking process that can never foresee all the possible economic and political shocks that can beset the economy. In some instances, actions undertaken to fine-tune the economy may turn out to be appropriate; but policies

that count on such a high degree of luck to succeed are typically not those that minimize the risk to economic performance over the long run.

Monetary actions designed to provide stable and moderate money growth can neither remove all the uncertainty that surrounds policymaking nor prevent the unforeseen shocks to the economy that may occur. However, stable, predictable monetary policy can minimize the potential damage to the economy by eliminating monetary policy itself as a source of uncertainty and as a potentially destabilizing force in the economy.

The Outlook

The consensus outlook of private forecasters is that the economy will continue to expand at a 4-5% real rate during 1984. That optimism does not preclude disruptions or circumstances not now envisioned by forecasters. It is instructive to recall that about one year ago the Administration's forecast of 3.1% real growth from fourth quarter 1982 to fourth quarter 1983 was generally regarded as overly optimistic; using the flash estimate for the fourth quarter, fourth-quarter to fourth-quarter real growth for 1983 will be about 6.1%. A major consideration left out of most private forecasts last year was the importance of the acceleration of money growth that began in the summer of 1982.

Federal Reserve policymaking is now primarily focused on targeting economic activity. The danger in this approach is that if the Federal Reserve waits until it perceives a slowdown in economic activity before moving to allow more money growth, it may be too late to prevent an undesirable downturn in the economy.